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The Diversification Controversy

As a young portfolio manager, I read an article (long ago misplaced) in *The Journal of Portfolio Management* on diversification. The study concluded that the optimal level of diversification in a portfolio was 12 stocks.

I never forgot that study and a few years later built my first "concentrated" portfolio. We run one today at LTI—and it represents our 12 Best Ideas.

Concentration can create massive wealth. A concentrated portfolio is not for everyone. They can generate outsized returns but also high levels of volatility. Still, the idea always intrigues me because the 12 Best Ideas strategy routinely (though not always!) outperforms our other relatively concentrated portfolios (25-35 names compared to an industry average of closer to 100 names).

As I was writing the 2nd Edition of *The Women's Guide to Successful Investing,* I cited a case study of a client who has half of his total net worth in Apple stock. Over the years I have encouraged this investor to diversify. He hasn't and he has been right; I have been wrong. The stock continues to climb higher. Almost every great fortune in this country has been achieved by a founder who owns a concentrated position in the stock of their company. Think Bill Gates, Larry Ellison, Elon Musk, Mark Zuckerberg, among others.

If you own the right concentration of companies, one could argue your risk is actually lower than an overly diversified portfolio. I regularly hear from new clients that they haven't participated in years of strong equity returns. When I look at their portfolios, I see hundreds of stocks or dozens of mutual funds which own hundreds of securities. Over diversification.

Consider the following quote (I just discovered) from Warren Buffett: *"Wide diversification is only required when investors do not understand what they are doing."* I have said as much over the years, but Warren Buffett somehow always says it better.

Investing is about being mostly right. To be sure we don't always get it right at LTI but the goal in investing, is to get your stock selection mostly right.

In *The Women's Guide* (1st edition) I wrote about a five-stock portfolio I provided in a print interview in 2003. I measured the performance from the publication date of April 11, 2003 through April 12, 2013. What astonished me was that only two of the stocks outperformed the S&P 500 (and one dramatically underperformed) but the five names collectively returned more than double that of the S&P 500*. Remarkable; particularly since the period included the Great Financial Crisis bear market.

We are entering the most important week of earnings. Many of the names we own in the 12 Best Ideas Portfolio are reporting this week. There will undoubtedly be volatility but we will use sell-offs to add to a number of our holdings.

Reach out to the team at LTI if you would like to learn more about the 12 Best Ideas Portfolio.

*It should be noted the 5-stock portfolio cited in an interview and measured over ten-years is merely an illustration. The calculation assumes the investor would have held every stock during the entire period and that may or may not have happened. The point is even with some dogs in a concentrated portfolio investors can do well over the long term.

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